

**STATE OF WASHINGTON  
STATE INVESTMENT BOARD**

Audit Committee Meeting  
Minutes

May 4, 2004

The Audit Committee met in open public session at 9:02 A.M. at the Washington State Investment Board (WSIB) office at 2100 Evergreen Park Drive SW, Olympia, Washington.

Committee Members Present:      John Charles, Chair  
   Debbie Brookman  
   Mike Colleran (designated representative for Mike Murphy)  
   Charlie Kaminski  
   George Masten  
   Bob Nakahara  
   Dave Scott

Others Present:                      Joe Dear, Executive Director  
   Gary Bruebaker, Chief Investment Officer  
   Theresa Whitmarsh, Deputy Director for Operations  
   Beth Vandehey, Internal Auditor  
   Alicia Markoff, Portfolio Administrator  
   Nancy Calkins, Senior Investment Officer – Public Equity  
   Kristi Walters, Executive Assistant

Paul Silver, Office of the Attorney General

[Names of other individuals attending the meeting are not included in the minutes, but are listed in the permanent record.]

Chair Charles called the meeting to order at 9:02 A.M., and identified Committee members present.

**ADOPTION OF MINUTES – FEBRUARY 2, 2004**

**Mr. Masten moved to approve the February 2, 2004, Audit Committee meeting minutes. Mr. Scott seconded and the motion passed unanimously.**

## **INTERNAL AUDITOR REPORT**

### **Audit Recommendations Status Report**

Ms. Vandehey introduced the quarterly report of outstanding audit recommendations. Two audit recommendations have been completed since February. The Operations and Investment divisions are working together to use the investment accounting system (FCS) to automate manual processes, and FCS and additional capacity at State Street Bank to automate performance reporting. Six recommendations remain. Ms. Vandehey introduced Diana Will to report on one of the outstanding performance reporting recommendations.

Ms. Will said that staff had met with representatives from the Office of Financial Management (OFM) to explain how the WSIB values some of its investments (lagged versus non-lagged). OFM has agreed that WSIB can use unit value returns for the June 30CTF balance. Ms. Will said that meetings will also be held with the Department of Retirement Systems, and Offices of the State Auditor and State Actuary to discuss the affect of this change.

### **Fiscal Year 2004-05 Audit Plan**

Ms. Vandehey introduced the 2004-05 audit plan which begins in June and runs through May 2005, based upon the Audit Committee meetings schedule. She provided an overview of how the internal audit function assists the Board and management in fulfilling their responsibilities. Ms. Vandehey reviewed the prior year's audit results and described the current year's objectives. She reported that the real estate audit is being carried over into the new plan to allow for on-site visits this summer. The plan is to present the real estate audit at the August meeting. Ms. Vandehey described how the audit universe is broken down into four broad areas: investment management, investment operations, external parties, and business operations. Ms. Vandehey described the internal audit risk factor 1-5 rating assessment, and added that a strategic planning risk factor was added to this year's rating. Ms. Vandehey reported the following audit areas for 2004-05: 1) real estate, 2) straight-through processing/fixed income compliance monitoring, 3) domestic passive manager, and 4) international active manager. Ms. Vandehey shared other work projects planned for the audit cycle, which includes a peer review to be reported on at the August meeting.

Mr. Nakahara asked why Ms. Vandehey chose to pass on some audit areas that had a high risk rating. Ms. Vandehey referenced Attachment B that describes what areas she plans to provide consulting services on, recently audited areas, and reasons why the remaining areas ranked high in points but were not included in the 2004-05 audit plan.

Ms. Nakahara asked about Ms. Vandehey's reporting structure. Ms. Vandehey said that she reports to the executive director administratively, but functionally reports to the Audit Committee. She explained that the recently approved internal audit charter provides that the Audit Committee will review the internal auditor's performance on an annual basis.

In response to a question from Mr. Colleran, Ms. Vandehey said that she had sufficient resources, time and support to accomplish the planned audit objectives. In response to Mr. Charles' question as to whether staff consulting would impair independence in any related subsequent auditing, Ms. Vandehey said that consulting complements the audit function in that she does not audit the areas where she consults and that such consulting is encouraged under the Institute for Internal Auditor standards. She said that she works with management to improve processes.

**Mr. Masten moved that the Audit Committee accept the Fiscal Year 2004-05 Audit Plan, and forward it to the Board for approval. Ms. Brookman seconded and the motion passed unanimously.**

#### **Daily Valued Funds Evaluation Report**

Ms. Markoff introduced the daily valued funds (DVF) evaluation report. Ms. Markoff reported that no errors above or below the tolerance level had occurred with respect to DVF operations. She credited the Portfolio Administration staff for a job well done.

#### **NONVOTING BOARD MEMBER SELECTION DISCUSSION**

Chair Charles reported that staff had placed general information relating to nonvoting Board membership on the WSIB website. The terms of two nonvoting Board members have expired but they are continuing and have expressed an interest in continuing to serve on the Board. Resumes from these two nonvoting Board members and from three other individuals were distributed to the Committee. Chair Charles asked the Committee if there was an interest in interviewing the three candidates and, if so, if members wished to do so prior to the next regularly scheduled Audit Committee meeting. Chair Charles invited comments from Committee members.

Mr. Colleran noted that the nominating procedures provide that all Board members are invited to nonvoting Board member interviews. Mr. Colleran also observed that the language on the website gives the impression that the Board does not currently have vacancies. He suggested that the language reflect the two current vacancies. Mr. Dear said staff would adjust the website posting. Chair Charles reported that the terms of two additional nonvoting Board members will expire at the end of 2004.

In response to questions from Mr. Masten, Mr. Kaminski said that one candidate had interviewed previously before the Audit Committee. Mr. Dear said that the candidates all met the criteria of being qualified in the field of investments with substantial experience.

**Mr. Masten moved that the Audit Committee direct staff to schedule interviews for the three nonvoting Board member candidates by the second week in June. Mr. Scott seconded.**

Mr. Colleran noted that the nominating procedures provide that references will be obtained for the candidates. Chair Charles directed staff to initiate the reference process.

**The above motion passed unanimously.**

## **PROXY VOTING DISCUSSION**

The Board directed the Public Markets Committee to study options for voting the Board's proxies and to review the current proxy voting policy. Staff prepared a memo outlining four options for voting the proxies.

The first option is to continue status quo and delegate proxy voting to the WSIB's managers as fiduciaries. The other options describe various ways to vote proxies using internal and external resources. Preliminary cost information is provided in the transmittal. Mr. Dear noted that it is too late to add staff for the 2005 proxy voting season. If the Board decides to vote proxies in 2005 instead of delegating voting to the managers, current staff resources would need to be reallocated from other important areas. Mr. Dear noted that the Board has been focused recently on domestic proxies, but that there are twice as many international issues. Staff has assumed that the Board would consider the options presented for only the domestic proxies at this time.

A discussion ensued regarding distinguishing corporations that are principally U.S. companies but have moved their headquarters off-shore for tax purposes, the workload created by proxy voting, the staff size in other pension funds that manage proxy voting internally, the WSIB's past experience in voting proxies, and whether the WSIB would have to move to a separate account. In response to a question from Mr. Colleran, Ms. Calkins said that BGI advises the WSIB how they voted after the fact and that staff annually reports this information to the Board. Mr. Dear said that BGI has reviewed the WSIB proxy voting policy and have provided written verification that there are no material differences with their own policy.

Mr. Masten asked if a policy could be developed that is more restrictive or focused and if there is any way to limit the number of proxies voted. Mr. Dear explained that if you vote, you vote them all. Mr. Bruebaker added that after researching an issue there may not be a position taken one way or the other so the proxy would not be voted, but the research aspect is still needed for the record.

Chair Charles noted that the Board belongs to the Council of Institutional Investors (CII). CII provides research and is up-to-date on the major issues in which the Board also has interest. Mr. Dear said that CII offers great value in identifying proxy and regulatory issues, but they do not provide comprehensive recommendations. There is still an exercise of staff judgment involved in voting proxies and each vote would require a record, even if it were outsourced.

Mr. Colleran said that he would like to have proxy issues with public impact tracked and for staff to notify BGI that their votes are being evaluated for the record. Mr. Charles asked that staff supply the Committee with a summary of BGI's past voting record of number of votes with and against management. Mr. Masten suggested that staff continue with the current process for the 2005 proxy voting season and to track index manager voting. He said that the Board could decide through the budget process if it makes sense to move forward. Mr. Dear reported that the budget for the 2005-2007 biennium would be brought to the Administrative Committee in July, prior to the Board workshop.

**Mr. Masten moved that the Audit Committee recommend that the Board limit study of proxy voting options to Barclays Global Investors domestic indexes. Ms. Brookman seconded and the motion passed unanimously.**

### **INTERNAL AUDITOR PERFORMANCE EVALUATION**

Chair Charles called the committee into executive session at 10:16 A.M. He said the purpose is to review and discuss the performance of the Washington State Investment Board's Internal Auditor. He estimated that the executive session would last until approximately 10:25 A.M., and after completion of the executive session, the committee would resume its open public session and might take action arising from the executive session or just adjourn.

[The executive session concluded at 10:38 A.M. and the open session reconvened immediately thereafter].

### **OTHER ITEMS**

There being no further business to come before the Committee, the meeting adjourned at 10:39 A.M.